II. THE COMMISSION'S ASSERTION THAT EXISTING RATES ABSENT A SPECIAL SHOWING ARE THE LIMIT IN A COS SHOWING IS CONSTITUTIONALLY INDEFENSIBLE WITHOUT ANY SUPPORT IN THE RECORD, WITHOUT FOUNDATION, AND CONTRADICTS CCTA'S ECONOMIC MODEL OF THE CABLE TELEVISION INDUSTRY.

The Commission proposes that absent a special showing "we would not entertain cost-of-service applications to justify initial regulated rates higher than the systems' existing rates." The Commission elaborates that a "special showing" would be a "demonstration of special circumstances or extraordinary costs."[32] The only basis offered by the Commission in support of the FCC position is "the presumption that most operators have set rates in an unregulated environment at a level to be fully compensatory."[33]

CCTA commissioned Barakat & Chamberlin[34] to study ten California cable television systems to test this hypothesis. Barakat & Chamberlin found that seven of the ten systems would be entitled, under normal COS rules and based on submitted numbers,

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[32] NPRM, ¶ 18.

[33] Id.

[34] Barakat & Chamberlin is an economic and management consulting firm specializing in regulated industries, including cable television, electric and gas utilities, water, solid waste, and telecommunications. The firm's professional staff has a national reputation in the areas of rate regulation, valuation, economic policy, and litigation support for these industries. In the area of cable television, the firm has analyzed the FCC's cable rate regulatory system on behalf of CCTA. In addition, the firm performs asset valuation and provides advisory services regarding state and local tax matters for cable companies.

to rates in excess of their current pre-reregulation charges.[35] The Barakat & Chamberlin analysis found a consistent economic pattern in the cable television industry. Rates are set low in the early years due to marketplace limitations. The cable system then attempts to build value, especially intangible value e.g., subscriber loyalty, market identification, and superior service through a trained work force. The system increases its value to customers through offering more channels of programming, it uses the economics of scale to consolidate neighboring operations and to secure programming at lower cost. As the cable system builds value, it raises rates to levels that are more consistent with its COS. Indeed, because of earlier losses or inadequate rates, later rates will need to exceed those of normal rate base regulation to recapture the expense of building market share, or, said differently, to reflect the accretion of intangible value through creation of subscriber loyalty, a trained work force, and other intangible values.

The idea that, without an extensive analysis of industry pricing, the FCC would presume that existing rates are fully compensatory is absurd, given the basic constitutional limitation that this would potentially impose on the cable operators. Even rates of regulated utilities at any point in time may not be

[35] This study contains confidential company information which was not disclosed to CCTA in order to comply with the antitrust laws. Pursuant to the Noerr-Pennington Doctrine the study was commissioned for the purpose of advocating COS rules at the FCC. CCTA is prepared to share the results of the study with the FCC pursuant to a non-disclosure order and confidentiality agreement between CCTA and the Commission.

"fully compensatory." Further, even assuming that there was some theoretical justification for this position (which CCTA believes there is not), cable operators should not be limited by the FCC's theory; their constitutionally protected rights to adequate rates based on their costs, not some theory, are at stake. The Barakat & Chamberlin analysis disputes this notion. Finally, such a rule also ignores the expectations of the investors who made investment decisions based on this economic pattern.

Therefore, the conclusion that cable operators should first have to justify even filing a COS study absent a "special showing" merely places an unnecessary additional burden on cable operators. Given that the stated goal of the COS methodology is that it be a "backstop" to the benchmark system, cable operators should be able to file COS showing without having to first demonstrate special circumstances or extraordinary costs.

Where COS indicates a higher rate is justified for a cable operator, the FCC should set a new price cap for that company and adjust the COS cap in the same manner as the FCC benchmarks. The Barakat & Chamberlin analysis indicates that cable companies may elect to charge lower rates in earlier years. Such a policy would let companies charge noncompensatory rates but provide the assurance that higher rate could be charged at a later time if and when the company so desired.

III. THE TRADITIONAL REGULATORY FRAMEWORK PROPOSED BY THE FCC IS INADEQUATE BECAUSE IT WILL NOT LEAD TO RATES IN THE ZONE OF REASONABLENESS.

In the NPRM, the FCC has proposed a COS methodology for setting rates that is similar to that traditionally employed by regulators of public utilities. While the FCC has requested comments on its proposed methodology, the FCC has indicated that it currently believes that COS should be based on a historical cost rate base that excludes acquisition premiums.[36] The NPRM suggests that the rate of return (ROR) on equity should be in the range of 12% to 17% and that the ROR on rate base should be in the 10% to 14% range after tax.[37]

Ultimately, this form of regulation will lead to a flood of administrative cases before franchise authorities and the Commission and, unless the Commission acts to modify its traditional approach, will result in confiscatory rates that the courts will not uphold.

A. The FCC Must Define More Fully Its Regulatory Goals.

The FCC has identified three goals for the COS regulatory system: (1) COS Regulation is a "backstop" to the benchmark system of regulation; (2) encouragement of technological development and the response to competition; and (3) congruity

[36] NPRM, ¶ 52. The FCC has not expressed an opinion on including the amortization of acquisition premiums in rates without a return on the unamortized balance.

[37] Id.

with the benchmark rates. CCTA believes that all three goals need to be expressed in terms of more detailed policy.

1. The COS and Benchmark Regulatory Methodologies Must be Integrated to be Constitutional and Workable.

After passage of the 1992 Act, the FCC asked for a wide variety of information concerning COS in its original Notice of Proposed Rulemaking on rates.[38] The December NPRM states:

> Allowing higher-cost systems to opt for cost-based regulation if the benchmark rate proved unreasonably low would, however, provide a safety valve to prevent confiscatory rates.[39]

Having received minimal comments on COS last winter, the FCC next discussed the need for COS rules in its Report and Order and Further Notice of Proposed Rulemaking in the rate regulation docket released on May 3, 1993. The FCC concluded that COS standards should be adopted:

> Such standards are necessary to define the costs and level of profits that will justify a rate increase and to permit a reasoned decision whether the proposed rate increase should be allowed.[40]

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[38] In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, MM Dock. 92-266, FCC 92-544 (rel. December 24, 1992) ("December NPRM"), Appendix B.

[39] Id., ¶ 36.

[40] In the Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 Rate Regulation, Report and Order and Further Notice of Proposed Rulemaking, MM Docket 92-266, ("May 3, 1993 Report and Order"), ¶ 270.

The Commission recognized a need for initial rules, reduced administrative burdens, and uniformity. The Commission went on to state:

> Moreover, because cost-of-service standards embody a fundamental balancing of the interests of consumers in paying a fair rate and of cable operators in recovering their costs and earning a reasonable profit, how this balance is struck could have a far reaching impact on the industry and cable subscribers. While it may be appropriate in the future for local franchising authorities to assume a larger role in setting cost-of-service standards for the basic tier as rate regulation develops, we believe that these standards should for now be established at the national level. The Cable Act of 1992 also envisions that the Commission, not local authorities, will establish standards and procedures for rate regulation of the basic service tier. Accordingly, we determine that the commission will establish cost-of-service standards for the basic service tier.[41]

The Commission outlined a variety of issues that needed to be evaluated when it predicted the present docket.[42]

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[41] Id. citing Jersey Central, 810 F.2d at 1177; Farmers Union Central Exchange, Inc. v. FERC, 734 F.2d at 1502; Mobil Oil Corp. v. FPC, 417 U.S. 283, 308-309 (1974); In Re Permian Basin Area Rate Cases, 390 U.S. at 792 (finding that the regulatory authority had a responsibility to consider not only the interests of producers in earning a fair return, but also "the relevant public interest, both existing and foreseeable); FPC v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944) ("It is not theory but the impact of the rate order which counts."); Id. at 603 ("the fixing of 'just and reasonable' rates involves a balancing of the investor and the consumer interests."); Bluefield Waterworks v. PSC, 262 U.S. 679 (1923).

[42] "In the Notice we proposed to adopt cost-of-service standards and solicited comment on the potential impact on subscribers and operators of the particular standards that we might adopt. The Commission will carefully balance competing interests and fashion standards that are fair to consumers and operators. By not unreasonably restricting a cable operator's ability to earn a reasonable profit, such standards can also assure the continued growth and success of the cable industry and the continuation of related benefits that it can bring to the public. We find, however, that the record concerning cost-of-service for cable

The FCC reiterated this position in the present NPRM:

- The FCC's benchmark regulatory framework "would not in all cases permit the cable operators to recover the reasonable costs of providing regulated cable service"[43];

- "[A] goal for the COS requirements ... will be that they form a 'backstop' for the benchmark regulation"[44]; and

- "Our [COS] requirements should permit cable operators to recover the reasonable costs of providing cable service and to attract capital, including the opportunity for reasonable earnings, while protecting consumers from paying inappropriate costs and unreasonable charges. . ."[45]

Without the implementation of an appropriate "backstop" COS regulatory methodology, the benchmark system results in rates

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service generally is not sufficient to permit the crafting of detailed cost-of-service standards for cable service required to achieve these objectives. For example, we are unable to gauge at this time the extent to which general disallowances of debt incurred to purchase cable systems in excess of replacement cost would affect the industry and consumers. Similarly, we do not have information on the impact of particular depreciation and amortization schedules for different categories of equipment. Nor do we have adequate information on the optimum level of cost averaging. We also do not have significant information on the cost of providing cable service. Accordingly, we will not adopt specific cost-of-service standards at this time. Instead, we will issue a Second Further Notice of Proposed Rulemaking in the near future looking toward adoption of cost-of-service standards." Id. at ¶ 271.

[43] Id., ¶5.

[44] Id., ¶7.

[45] Id., ¶8.

that would, for some systems, be confiscatory and thus would not comply with the legal requirements.[46]

[46] See Section I.B., supra. CCTA notes that in denying a request for stay of the cable television benchmarks, the Commission departed from over eight months of reasoned requests for information concerning COS: "Petitioners' claim that they are unable to avail themselves of the cost-of-service option because the Commission has not yet adopted specific rules to govern cost-of-service showings is without merit. This position assumes that the Commission will not take actions consistent with minimum statutory and constitutional standards that necessarily would govern the Commission's (and local franchising authorities') evaluation of any cost-of-service showing. Although comprehensive cost-of-service rules have not yet been adopted, the statutory standard of "reasonable" rates, which ultimately would govern such rules, is sufficiently concrete to protect the interests of both cable operators and subscribers in the interim. Under established ratemaking principles, the lowest reasonable rate is one that is not confiscatory in the constitutional sense. A just and reasonable, nonconfiscatory rate should be "sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital." The rate should also be "commensurate with returns on investments in other enterprises having corresponding risks." MM Docket No. 92-268X, Memorandum Opinion and Order and Further Notice of Proposed Rulemaking, August 10, 1993 citing: Cf. AT&T v. U.S., 299 U.S. 232, 246 (1936); FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 585 (1942); Hope, 320 U.S. at 603. (Emphasis added.) CCTA disagrees with the notion that Hope and its progeny alone define sufficiently concrete standards to govern COS rules for the cable television industry. To begin with, the cases cited by the FCC involve regulated utilities which do not have the risks, industry structure or regulatory history corresponding to those of cable television. See Section I.B.4., supra. Realizing that other companies are litigating this question, CCTA asserts that the standards for COS rules for cable television companies are not sufficiently concrete for operators to understand because of the distinctions between monopoly utilities and the cable television industry as set forth by the United States Supreme Court in the Duquesne case. CCTA further asserts that the FCC must adequately examine the economic impact of COS rules on the cable television industry before propounding such rules in order to have a reasonable basis to draw conclusions about issues such as original cost, acquisition premium, and rate of return. The Constitution requires an evidentiary record for such rulemaking.

The failure to provide for a COS regulatory system that meets these legal requirements would have adverse effects for the FCC, franchise authorities, subscribers, and the cable television industry. The FCC has recognized as much in its May 3, 1993 Rate Order.[47]

Therefore, the goal here is to determine a COS regulatory system that balances the interests of consumers and cable operators and that meets the legal requirements and congressional intent of the act. By this CCTA refers to a system of COS regulation that meets these requirements for all companies in a "workable" regulatory system.

The Commission's position is that companies that elect COS but that fail to meet the burden of supporting their rates with a COS case may receive rates less than the benchmark. In the absence of any Commission rules on COS, such a position appears punitive and unreasonable. The Commission is blatantly attempting to coerce cable television companies into giving up their constitutional right to a reasonable return on threat of imposing unknown and potentially punitive COS rules and standards. Second, the possible down-side risk that the companies using COS could obtain a rate below the benchmark rates is obviously another concern. CCTA believes that this inappropriate rule will further discourage the adoption of COS.

For the industry, the failure to develop a workable system would mean that many companies would not be able to obtain

[47] See Footnotes 41 and 42, supra.

reasonable rates as required by the Constitution. Failure to enact a workable system would probably mean either that the system would be challenged in the courts or that wholesale challenges to ratemaking would be filed by cable companies. In either event, the system would have to be modified. Challenges to the rules would also result in regulatory uncertainty and a larger FCC caseload, neither of which is in the interest of the FCC, franchise authorities, subscribers, or the cable television industry. A large number of cable television systems could require COS to obtain an adequate return.[48]

2. To Be Consistent with the Intent of Congress, COS Rules Must Encourage Technological Development And Enable Cable Operators to Respond to Competition.

The FCC has properly noted the role of its COS regulatory approach with respect to encouraging the appropriate investments in the telecommunications infrastructure and enabling the cable television industry to compete.[49]

These two goals are essential. It is widely recognized that regulation in general and inappropriate regulation in particular can provide a serious disincentive for companies to invest in new infrastructure and technologies. The cable television industry is currently at a crossroads in terms of both its investment in new technology and its emerging video and telecommunications competition. Therefore, it is critical to establish a COS

[48] See Section II, supra.

[49] See Section IV, infra.

regulatory system that is responsive to these requirements. Without this, the Congressional intent in the 1992 Cable Act will not be met for all operators.[50]

3. It Is Important For The FCC To Define Carefully Its Third Goal For COS And To Recognize The Interrelationship Between The Pre-regulation Prices, Competitive Prices, Benchmark Prices, And COS-based Rates.

The FCC has noted that:

> "We solicit comment on whether our regulatory framework for cost-based rates should also be guided by the goal of producing rates that approximate competitive rate levels, i.e., rates that approach the operators' costs."[51]

CCTA believes that the FCC must fully explore and articulate the relationship between competitive market rates, benchmark rates, and COS-based rates. Failure to do so could result in seriously misguided regulations. Specifically, it would be an oversimplification to assume that COS-based rates equal the rates that would exist in a competitive marketplace.

In general, economic theory and CCTA's preliminary analyses suggest that the COS-based rates will in many cases exceed the benchmark rates.[52] The benchmark rates basically equal the industry rates for the cable systems without effective competition as of September 30, 1992 as determined by the number

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[50] See 1992 Cable Act, Section 2(b)(3).

[51] NPRM, ¶ 10.

[52] See Section II, supra.

of channels (and other factors) and reduced by 10%. It is instructive to examine the relationship between COS-based rates, the rates in effect at the time of regulation (pre-rate regulation rates), and cable rates in markets with effective competition (competitive rates).

COS-based rates are, in essence, average cost rates based on the system's average historical accounting cost of providing service. Pre-rate regulation rates can be either higher or lower than average cost rates. They may be higher if there is a high demand and willingness to pay for cable services, a situation that enables the cable firm to optimize its profits at a price above its current COS-based rate.[53] However, pre-rate-regulation prices can also be below average cost rates, particularly in the case where the cable system is attempting to increase its subscriber base or compete with substitutes in the market.[54] Thus, in some markets, even though only one cable system exists, the penetration of cable is still fairly low because of the low value placed on cable services and/or the existence of many substitutes.[55]

Consider now the competitive rates. It is a basic axiom of economics that competitive rates tend toward marginal costs, not

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[53] The cable operator's ability to do this may be justified by its prior prices which were below COS.

[54] See Footnote 67, infra.

[55] This situation is substantiated by the fact that industry returns have traditionally been below the reasonable cost of capital. See Section III.B.1.b, infra.

average costs. Because marginal costs for serving additional cable customers are low relative to average rates, competitive rates may be well below COS-based rates.

As a result, the benchmark rates, which represent the September 3, 1992 average industry rate reduced by 10%, may well be below -- and perhaps significantly below -- current COS-based rates. This discrepancy has implications for the benchmark rates. It also suggests that many companies may qualify for COS-based rates.

B. The Traditional COS Methodology Proposed by the FCC Cannot Be Applied to the Cable Television Industry without Adjustments in Methodology to Reflect the Market Economic and Financial Realities of the Industry.

The FCC has proposed COS rules that are similar to those traditionally applied to monopoly utilities. The basis for the rules governing rate regulation of utilities is derived from Hope and other cases governing the standard for regulating utilities under COS. The FCC and other federal and state regulatory agencies have developed these rules in great detail since the Hope decision.

The cable television industry differs significantly from traditional, regulated monopoly utilities. The cable industry is a relatively new industry undergoing continual technological and organizational change. As a result, the FCC cannot assume that the traditional utility COS regulatory approaches will work for cable television. Failure to consider properly the specific structure of the cable industry and come to a reasoned conclusion regarding the proper type of COS regulations to impose will violate the cable industry's rights and likely lead to regulations that are confiscatory.

The key industry factors described and analyzed below show that traditional COS regulation will not meet the legal requirements for a rate regulatory system.

1. The Economic Structure of the Cable Television Industry Is Not Conducive to Traditional COS Regulation Given That the Cable Television Industry May Not Be Able to Charge Rates Equal To COS Because Cable Television Service Is More Price Sensitive Than Utility Service.

Traditional COS regulation is premised on the assumption that the regulated company will be able to charge the rates resulting from the COS determination. However, the cable television industry's ability to charge these rates may be limited due a large number of factors. Where these limitations exist, the FCC must reflect this market reality in the design of its overall COS regulations.

The cable television industry is subject to market and price pressures that, in some cases, limit its ability to charge rates equal to full COS. While cable television has a large subscriber base, the national average penetration of slightly above 60%[56] indicates that there is a large number of customers who have not elected to purchase cable service.

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[56] Paul Kagan Associates, Inc., Cable TV Financial Data Book, June 1993, Page 7.

Price has a major role to play in determining the level of market penetration. If cable companies drop their price, they would expect their subscriber levels to increase. Economic theory states that, prior to rate regulation, cable companies adopted a pricing strategy (consisting of both present and future prices) that optimized their long-term return. This pricing strategy implicitly, if not explicitly, traded off the level of cable system subscriber demand (penetration) versus price to achieve a total maximum profit.

When a new cable television system is constructed, it takes a period of time, often many years, for the new system to obtain a sufficient number of customers to provide a level of revenues that will cover costs. Thus, in addition to the normal theoretical trade-off between price and demand, there is the real world lag associated with building up the demand.

a. COS-Based Rates Will Not Be Compensatory If Costs Are Too High or Subscriber Penetration Is Too Low.

Assuming for a moment the traditional COS model, the rate for a cable system would be primarily a function of the level of capital investment and fixed operating costs per subscriber. As the subscriber base increases, the average rate would decrease and vice versa. Further, as the fixed operating and capital costs increase, the COS-based rates would increase.

In the traditional COS-based ratemaking process, the revenue requirement (RR) is determined. Then a rate (R) is designed based on the expected number of subscribers (S) expected to produce the

RR, that is, R = RR/S. However, the level of subscribers is sensitive to price, as is RR. So, as price increases, the level of subscribers goes down. RR also goes down but only incrementally. A company's income is thus I = (R*S(R)) - FC - (VC*S), where FC is the fixed costs of the system, VC is the unit variable costs, and S is a function of R, S(R). The COS-based rate is thus the rate R = FC/S + VC provided that the company can competitively charge the rate R and obtain a subscriber base S.

From this example, it is apparent that if FC is too high or the number of subscribers is too low relative to the level of fixed costs, then the COS-based rate, R, is not compensatory, that is, it does not generate the income that is required. Many systems will be in this position. In particular, systems with high costs relative to the number of subscribers will receive insufficient income.

To determine the workability of the FCC's proposed COS approach, the FCC must calculate rates, then determine if they are sustainable. Preliminary analysis shows that some COS rates are so high and the number of subscribers so low that there will be no compensatory and sustainable rate. The FCC must modify its COS methodology to account for those systems where current COS rates are not sustainable. One way to do this would be for the Commission to set a price cap based on COS rates trended for inflation, whereby systems which could otherwise justify COS rates materially above their current rates would not have to justify rate increases for a period of time, for example, five years.

b. The Fact That Cable Companies Make Noncompensatory Investments in the Short Term in the Hope of Long-Term Profitability Must Be Reflected in the COS Regulation.

The sensitivity to market pricing fundamentally affects the investment and return patterns of the cable television industry. The cable industry makes noncompensatory investments in the short-term in the hope of long-term profitability. To the extent that investors have assumed additional risks by investing in cable television systems that were not compensatory in the short-term, these risks must be compensated for in the long-term and reflected in the COS regulations.[57]

While a system investment may not be compensatory in the short-term, it may be compensatory in the long-term. This situation can occur for three reasons. First, the fixed costs decline as the system investment is depreciated. Second, the level of subscribers increases due to a number of factors, including population growth, additional market penetration, improved programming, and other factors. Third, the sustainable price, R, can increase over time due to inflation or the creation of intangible value.[58] As a result of these factors, the profitability of a cable system improves over time, and, thus, it

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[57] See Sections I.4., supra, III.B.5., infra.

[58] See Section III.B.4, infra.

is economically rational for a firm to invest in a cable television system that is not compensatory in the short-term but is compensatory in the long-term.

This trade-off of short-term losses for long-term gains is illustrated in Table 1.[59] In the early years a company's COS rates exceed its market (or benchmark) rates. In the later years, however, this pattern is reversed. As the company is unable to charge COS rates in the early years (due to the price sensitivity of cable service discussed above), the company will be deficient in its overall, life-cycle earnings. This situation is referred to as the "front-end load" problem when COS rates are in excess of what the market will bear.

A monopoly utility with an adequately large customer base is generally able, and is generally given permission by regulators, to charge rates to recover its costs. In general, cable companies have not been as fortunate. As a result, these companies have realized "start-up costs" associated with the establishment of cable systems. These start-up costs are real and legitimate costs associated with the establishment of the systems and must be recognized as such. However, they do not appear in a traditional COS system of accounts.

These costs are a key characteristic of the cable television industry and must be carefully incorporated into the FCC's COS regulations. In some systems the COS-based prices would greatly exceed current rates, and the result would be prices that are not

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[59] Appended hereto as Attachment "A".

compensatory and, therefore, prices that would not be sustainable. Thus, the income maximizing price in the short run for these companies would be a price below the COS-based price and that would be compensatory in the short run.

When a regulatory system yields COS-based rates that exceed "market" prices, then the constitutional requirement to permit the company to earn a fair return requires that the regulatory agency implement a COS approach that considers these competitive issues.[60]

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[60] See Section I.B., supra. This constitutional requirement is illustrated in the AT&T case. This case concerned an FCC rate refund rule applicable to AT&T. The refund rule was described by the court: "Under the refund rule, the Commission will set a target rate of return, and will require carriers to file rates reflecting the target, for a subsequent two-year period. The commission will review the filed rates to determine whether they are just and reasonable, and in particular whether the carrier has properly incorporated the target return the Commission has set. This process does not significantly differ from what the Commission and carriers have done in the past. But the refund rule also requires each carrier to compare the revenue it actually received during the two-year period with the revenue that, all else being equal, achievement of the target return plus a 'buffer' increment would have produced during that same period. If the carrier received more revenue than the target with the buffer would have produced, it must refund the excess to its customers." AT&T, 836 F.2d at 1389. The court overturned the rule: "The refund rule requires the carrier to refund earnings above the upper bound of target plus buffer, while the carrier may not recoup any shortfall in its earnings below the target. A carrier cannot be expected to receive earnings each year at precisely the prescribed rate of return, and from one two-year period to the next it must forfeit any excess earnings while absorbing any deficiency. Thus, over the long run the carrier is virtually guaranteed to fall short of earnings its required target rate of return on its combined operations for all such periods viewed together." Id. at 1390. Thus, while under the refund rule the carrier would earn an adequate return in any one year, the court found that over the long run the carrier would fall short of earning an adequate return. Thus, the court's opinion is based on the constitutional requirement that the returns must be adequate over the long-term.

The FCC must use reasoned decision making to determine the type of COS system that would recognize this key characteristic of the cable industry.[61] The FCC must therefore reasonably investigate alternative COS regulatory approaches and implement an approach that will provide cable company investors with an adequate rate of return over the long term that is commensurate with the level of risk they assumed. The requirement to investigate reasonable alternative COS methodologies is illustrated by the adoption of a market-sensitive COS methodology by the FERC after the Farmers Union decision in the D.C. Circuit.[62] The investigation of alternative COS approaches is

[61] See Section I.A., supra.

[62] After Farmers Union was remanded by the courts to the FERC, the FERC applied reasoned decision making to the issue of oil pipeline rates which also possessed a front-end load problem. The FERC adopted an alternative approach to traditional cost of service known as Trended Original Cost (TOC). FERC explained its reasons as follows: "The Commission adopts TOC over net depreciated original cost because it is a theoretically acceptable alternative that after the switch from a valuation will help newer pipelines with higher rate bases to compete with older pipelines with lower rate bases and will help them compete with other modes of oil transport and so will tend to foster competition generally. This is so because TOC mitigates the front-end load problem for new pipelines. The [FERC] discussed in detail the front-end load problem in Opinion No. 154 and reaffirms what was said there. In brief, a front-end load occurs under net depreciated original cost because under that approach rate base declines over time. Hence, the company's allowed return for its equity cost of its capital declines over time. This means that the company's allowed equity return is bunched in the early years of its property's life when its rate base is still large. The problem is that owing to competition a pipeline may not be able to charge rates high enough to recover that bunched income. And those lost revenues are gone forever. TOC, on the other hand, defers income until later years by capitalizing the inflation factor into the equity rate base. As time goes by and competitor's prices rise because of inflation, the company under TOC can raise its rates to recover the deferred

imperative given the nature of the cable industry. It is also indicated by the Congressional policies underlying the Cable Act.[63]

The FCC could adopt one or more of several alternative approaches, the underlying principle being that the FCC should permit cable companies, at their option, the flexibility to charge prices below COS in the short term but to raise prices above COS in the long term where the premium above COS in the long term is linked to the deficiency that occurred in the short term. Some of the alternative approaches are as follows:[64]

- Trended Rate Base. In this method, companies are allowed a lower return on rate base but the rate base is allowed to increase each year by the amount of the

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income and still compete. In opinion No. 154, the [FERC] recognized the front-end load problem but retained valuation as the inflation-sensitive rate base. But, the [FERC] stated that a rate base linked to inflation, such as TOC, would be the simplest and perhaps best approach. The Commission now takes that approach." FERC Opinion No. 154-B, pages 12-13, 31 FERC page 61, 377.

[63] See Section IV, infra.

[64] We are cognizant that under Hope it is the end result that is to be judged. Therefore, it is possible that any of the above, or some combination, will result in reasonable rates. However, at the same time the choice of policy instrument will critically determine the workability of the alternatives. Finally, consistent with Farmers Union, the FCC is required to draw conclusions about "significant and viable" alternatives. See Section I.A., Footnote 10, supra. CCTA asserts that each of these alternatives is "significant and viable". See Footnote 66, infra.

short fall. Trended Original Cost is one variation on this method.[65]

- Inclusion of Start-up Costs. Start-up costs could be included or reflected in future rate bases.
- Plant Phase-in. In this method, companies would be allowed to phase in their rate base. The portion not currently included in rates would be allowed to earn interest during construction (IDC).
- Higher Rates of Return. Higher rates of return can be authorized reflecting the shortfall in the early years.

We refer to the first three methods collectively as the "deferred cost recovery methods."[66]

From an economic perspective, at least a portion of the difference between market-based rates and COS can be considered a legitimate "start-up" cost of doing business. This start-up cost should be included a company's rate base. The start-up cost is similar to the treatment of construction work in progress (CWIP) before it is placed in service. Put simply, although a cable television system may be physically available for service, it is clearly not economically available until there are sufficient subscribers providing the required revenues. Under COS, utilities typically keep assets in a CWIP account until the project has

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[65] See Footnote 62, supra.

[66] For discussion on these methods applied to utilities see: Charles R. Philips, Jr., The Regulation of Public Utilities, Public Utilities Reports, Inc., Arlington, VA, 1988, Chapter 8; Sally Hunt Streiter, "Trending the Rate Base," 109 Public Utilities Fortnightly 32 (May 13, 1982).

been completed. At that time the utility is allowed to place the assets in rates. In some cases where the assets cannot be entirely placed in rates, the companies are allowed to phase in the assets and continue to accrue Allowance for Funds Used During Construction (AFUDC) on the portion that is not in service. The costs (or allocated portion) associated with the investment are capitalized until the asset is placed in rate base. The FCC should adopt this or a similar approach as an option for cable television systems to give them the option to minimize rates in the short term (while subscriber levels and rates are constrained) and to earn adequate returns in the long term.

This method is one of a number that could be used by the FCC to vary the time pattern of cost recovery. The exact method adopted is not as important as allowing for some method to be adopted.

Thus, to provide adequate and reasonable rates, the FCC must address the issue of market competition from all information and entertainment sources[67] in so far as the marketplace limits the

[67] Irrespective of how the Act defines "effective competition", 47 U.S.C. 543(1), cable television operators face or will face unique competitive forces in each marketplace from over the air broadcasting, MMDS, video dialtone, movie theaters, video tape rental stores and DBS. See Comments of CCTA, In the Matter of Reexamination of the Effective Competition Standard for the Regulation of Cable Television Basic Service Rates, MM Docket No. 90-4, filed February 14, 1991. If the District Court decision enjoining enforcement of Section 613(b)(1) of the Cable Act by the United States or the FCC is not overturned (Chesapeake and Potomac Telephone Co. of Virginia v. United States, et al., Civil Action No. 92-1751-A (E.D. Va. Aug. 24, 1993)), cable television operators will soon face competition from Local Exchange Carriers (LEC) within the LECs' service areas.

rates that can be charged -- hence the returns earned -- by cable companies. To do otherwise would subject a large number of companies to inadequate rates now because of the competition they face, and inadequate rates later because of the combination of the FCC's COS and benchmark regulatory system.

Deferred cost recovery methods are also in the consumer interest. The cable companies that elected a deferred cost recovery approach would have lower short-term rates and a higher level of subscribers. Moreover, this approach would enable companies to increase subscriber levels with the result that long-term rates will also be lower. Thus, providing companies with the ability to modify the time path of cost recovery assists both the consumer and the cable company. Some consumer groups may argue that it is inappropriate for the companies to reduce short-term prices and reflect the short-term start-up costs in long-term rates. This argument is only true if their goal is to set confiscatory rates in the short term and not permit the full recovery of costs over the life cycle of a system investment.

Finally, we believe that the implementation of a flexible method by which cable television operators can ultimately realize reasonable return on investment under COS where the marketplace forces them to price below cost in the short term is supported by the policy goal with respect maintaining the cable industry's ability to expand its technology infrastructure and its ability to compete.[68] Simply stated, cable's unregulated competitors are

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[68] See Section VI, infra.

able to reduce their short-term prices to gain long-term market share. Therefore, cable companies should have the same capability and not be penalized in the long term for meeting the competition in the short term.

2. Unlike COS for Regulated Utilities, the COS Regulations for Cable Television Must Permit Recovery of Acquisition Premiums.

Unlike utilities that have been regulated over a large number of years, the cable television industry has over the past ten years undergone a period of consolidation through acquisitions. The acquiring companies have generally paid a premium over the value of the cable plant for the systems they have acquired. The acquiring companies are entitled to a return to the equity commensurate with returns on investments in other enterprises having a corresponding level of risk.[69] The balance sheets of the acquiring companies contain significant values associated with the intangible assets of these companies (referred to as acquisition premiums) that may not be included in the rate bases under traditional COS regulation. The COS regulations must reflect these acquisition premiums if they are to avoid being confiscatory. Therefore, the FCC's regulations must recognize the acquisition premiums.

These acquisition premiums are significant. During the ten years ending December 31, 1992, over 3,300 acquisitions of cable systems occurred, representing total sales of over 47.4 million

[69] See Section I.B., supra.